JAPAN · ECONOMIC · INSTITUTE

JEI

REPORT

A Two-Part Report: A and B

NO. 27A July 13, 1990

MONETARY POLICY IN JAPAN

Summary

Price stability amid Japan's continuing economic growth during the 1980s has been remarkable. The low rate of inflation calls attention to the handling of monetary policy. Since the 1970s the Bank of Japan, which has primary authority over monetary matters, continuously has adjusted the way in which it conducts policy but consistently has placed great importance on price stability. At times, ongoing changes in Japan's domestic and international financial structure have complicated monetary policy. While the goals differ only slightly, monetary policy as practiced in Japan differs in significant respects from monetary policy in the United States and other industrialized countries. Some analysts see signs that BOJ would like both its practices and its independence to conform more closely to that of the Federal Reserve Board, its American counterpart.

What Is Monetary Policy?

Monetary policy basically involves money. At least as long as governments have maintained a means of payment for goods and services, they necessarily have had a policy toward controlling that means of payment. Thus, they have had a monetary policy. That policy must take account of four dimensions of the supply and the demand for money: its amount, its intensity of use, the quantity of goods and services for which it serves as a means of payment and the price level of these goods and services.

Money can be thought of as the means by which the production and the consumption of goods and services are financed. If money has high velocity (is

used intensively), then less is needed to finance any given level of transactions for goods and services at a given level of prices. Similarly, if more goods and services are produced and purchased, then change occurred in one or more of the other three variables: the amount of money increased, its velocity rose or prices dropped. (More formally, this relationship can be expressed by the following equation: money times velocity equals prices times output.)

The Controversy Over Monetary Policy

Monetary policy has to do with a government's direct or indirect control of one of these four elements -- the amount of money -- and how that affects or is affected by the other three. Unfortunately, the causal relationships are murky at best. For example, some experts believe that an increase in the money supply leads almost directly in many situations to an increase in the level of prices because they do not believe changes in the money supply significantly affect velocity or output. According to this school, monetary policy has little positive purpose in solving unemployment problems.[1] This suggests that the government should alter the supply of money only with great reluctance since the risk of inflation is great and the potential payoff in terms of increased output minimal. Most economists would agree that when output already is high, money expansion is unusually risky. Even when this rare consensus among economists has been present, Japanese prime ministers, American presidents or Latin American dictators have not necessarily accepted the economists' advice.

Other experts suggest that the causation runs at least partly in the other direction -- that increased transactions in goods and services call forth more money. Still others believe that velocity is highly capricious, leading to unstable relationships among the other three variables. Complicating most of these theories still further is the now widepread belief that past monetary policy influences the effectiveness of future policies. For example, a country that has enjoyed many years of price stability could be expected to react differently to an expansionary monetary policy than one with a history of inflation. In the first instance consumers might believe that the increased funds in their hands represent a real gain and respond accordingly. In the latter case they would run for cover (get rid of money) to protect themselves against the expected price increases; such a response would boost velocity and virtually guarantee the feared inflation.

Exchange rates necessarily are a dimension of monetary policy. Under a system where currency values float freely, a drop in interest rates (a monetary expansion), for example, has several important effects. To the extent that the larger money supply leads to higher rates of inflation, the value of the

[1]Some experts believe that this view is at least implicit in theories of real business cycles, for example. See N. Gregory Mankiw, "Real Business Cycles: A New Keynesian Perspective," The Journal of Economic Perspectives, Summer 1989, p. 81. For an opposing view, see Charles I. Posser, "Understanding Real Business Cycles," The Journal of Economic Perspectives, Summer 1989, p. 70.

The JEI REPORT (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

currency will fall in international markets to offset the reduced competitiveness of exports and domestic substitutes for imports. Even without inflation the boost in aggregate demand that results from lower interest rates can be expected to increase the demand for imports, leading to a lower exchange rate to maintain exports. In addition, lower domestic interest rates will make financial instruments at home relatively less attractive compared to options overseas; this leads to a capital outflow, a demand for foreign exchange and a further drop in the local currency. Finally, changes in the exchange rate could feed back on price levels. For example, should the domestic currency depreciate, import prices will rise, other factors equal. This could complicate the objective of price stability.

Japanese Monetary Policy: Traditional Practices

During and immediately after World War II Japan had a monetary experience that leaves scars even today. While good data are scarce, some gross national product statistics indicate the extent of the disaster. Based on Japan's GNP deflator -- a broad measure of inflation -- prices were 127 times higher in 1950 than in 1940. Over the same period GNP dropped in real terms. In addition, nominal financial assets rose only one-sixth as fast as prices, suggesting an enormous drop in purchasing power for those holding financial assets.[2] In short, rapid inflation was associated with a period of economic decline and the failure of money as a store of value, one of its principal functions. No monetary policy could have prevented the economic hardship that resulted from World War II and its aftermath. However, the memory of the hyperinflation of that period undoubtedly served to heighten inflationary fears in subsequent years.

In the early postwar years those fears were offset by the perceived need for economic recovery and expansion. From the 1950s to the early 1970s the Bank of Japan pursued a monetary policy that accommodated extremely rapid rates of growth while producing relatively low rates of inflation, although prices rose more rapidly than in the United States during this period. Consumer prices increased 5 to 6 percent annually from the early 1960s to the early 1970s, while real GNP often grew at double-digit rates. In accomplishing these objectives BOJ used policy instruments that were unusual by the standards of the Federal Reserve Board and the central banks of most other industrial countries. In many respects these tools continue in use to this day, although not to the extent that some analysts claim.

Then and now BOJ possessed, in principle, the same policy tools as the Fed has in this country.[3] For example, it could change bank reserve requirements. By reducing reserve requirements, BOJ could hope for a multiplier effect as banks lent out a higher proportion of funds on deposit and, thus, helped create a larger money supply. This is a blunt instrument that neither

[2]Cited in Serguey Braguinsky, "A Criticism of Monetarism -- With Some Points from the Japanese Experience," Keio Economic Studies, 25(2), 1988, p. 43.

[3]For a detailed description of BOJ policy instruments, see Yoshio Suzuki, The Japanese Financial System (Oxford, England: Clarendon Press, 1987), pp. 317-326.

the Fed nor BOJ has used often. The Fed long has preferred another option also available to BOJ: open-market operations. In such cases the central bank can create liquidity in the banking system by buying securities from the banks or the public, thereby typically leading to an increase in money in the banking system and throughout the economy. This process also can operate in reverse. Selling securities to banks drains liquidity and is likely to lead to a monetary contraction.

The open-market option works best if securities markets are well developed, which certainly was not the case in early postwar Japan. Instead of open-market operations BOJ reached for a third alternative that the Fed uses relatively little: lending to financial institutions. As with open-market operations the central bank can create liquidity in the banking system by such lending. This option led to the phenomenon of "overloans." Banks were able to lend out more money than they had on deposit because of their ability to borrow money from the Bank of Japan on favorable terms.

Overloans led to another characteristic feature of the period: "window guidance." If BOJ felt the expansion of credit was excessive, it would exert pressure on the banks in the form of administrative guidance to curtail lending. Strictly speaking, adherence to such guidelines was voluntary, but BOJ's lending on favorable terms to the same institutions certainly gave it considerable leverage.

With such a critical role played by BOJ's lending mechanism, the discount rate (the cost of such funds) had a high profile. The bank changed the rate infrequently, giving each change all the more significance. It obviously was -- and still is -- an important signal of the direction of BOJ policy; higher rates indicate a tighter monetary policy, lower rates the reverse. Even banks that were not borrowing from BOJ paid close attention to the discount rate to determine which way the monetary wind was blowing. In addition, the discount rate directly or indirectly is linked to a number of other critical interest rates. After a discount rate change a consultative process led to the adjustment of other administratively determined rates.

Recent Monetary Policy

The early 1970s ushered in an era of rapid change. The first important development for BOJ came with the breakdown of the Bretton Woods regime of fixed exchange rates in 1971. The bank bought up large amounts of foreign currency in an effort to save the system, but this action created excess liquidity in the economy and brought down market interest rates independently of BOJ-posted rates.[4] Of course, once flexible exchange rates became the norm, BOJ gained increased flexibility, at least on paper. Money could be tightened or loosened without necessarily having to defend the exchange rate at the same time.

The 1973-74 oil crisis created further inflationary pressures that the existing system was poorly equipped to handle. As the surge in oil prices worked its way through the economy Japan experienced its worst inflation since

[4]This example is drawn from Robert Alan Feldman, Japanese Financial Markets (Cambridge, Massachusetts: MIT Press, 1986), pp. 118-119.

the immediate postwar period. From 1955 to 1970 consumer prices rose a cumulative 88.3 percent, using 1975 weights. In just the next five years they jumped 72.4 percent on the same basis.

Other changes were occurring independently of the Bretton Woods collapse and the run-up in oil prices. Corporations had less need to borrow from banks, which, in turn, became less dependent on BOJ lending. In addition, the government began running large budget deficits that required financing. Absorbing these government bonds created new challenges for the financial system. Finally, as financial markets became more internationalized -- a process that accelerated in the early 1980s -- banks acquired more options to act independently of BOJ.

These changes suggested that the system of administratively determined interest rates could not continue unaltered. By necessity an increasing number of rates floated in response to market conditions. Others, while nominally market-determined, in fact seemed to continue to take their cue from the posted rates. As more and more rates were freed, adjustments of the remaining rates became increasingly frequent. The unconditional call rate, for example, was changed only eight times in 1976 and 20 times in 1977, but by the early 1980s it was being altered as often as 200 times a year.[5]

In any case, as posted interest rates and direct BOJ lending lost some of their efficacy as policy tools, new procedures arose to take their place. In June 1972 BOJ began open-market operations using commercial bills. In May 1981 it began selling short-term government securities on the open secondary market to absorb excess liquidity, albeit in small amounts. In 1985 the bank also began buying government securities in periods of deficient liquidity. In March 1986 it began open-market operations in certificates of deposit. As of 1986 Robert Alan Feldman, then an economist at the International Monetary Fund, concluded that the new tools and the old ones coexisted.[6]

Financial liberalization continued through the 1980s. (For details of recent financial liberalization measures, see JEI Reports No. 20A, May 18, 1990 and No. 27B, July 13, 1990.) Among those moves closely related to the implementation of monetary policy have been several within the past two years.

- In November 1988 BOJ made a major change in the way in which it conducts open-market operations. It shortened the minimum maturity of commercial discount bills -- one of its principal intervention instruments -- to one to two weeks, prior to that the shortest maturity had been one to three months. By using such a fast-maturing instrument, BOJ felt it could better exert its will. Extremely short-term rates depend almost entirely on the level of bank reserves, over which BOJ can exert direct influence by its lending, open-market operations and other policy instruments. By contrast, even one- to three-month bills are affected by investors' expectations of inflation and expected, as opposed to actual, BOJ policy. In moving toward a shorter-term instrument, BOJ also was conforming more closely to Fed practice.

[5]Thomas F. Cargill and Shoichi Royama, The Transition of Finance in Japan and the United States (Stanford, California: Hoover Institution Press, 1988), p. 77.

[6]Feldman, op. cit., p. 120.

• In May 1989 BOJ began buying commercial paper as an open-market operation. At the time commercial paper was quite new in Japan, having been introduced in November 1987 (see JEI Report No. 44B, November 20, 1987).

• In December 1989 BOJ began lending to foreign banks with offices in Japan. Since such loans may be attractively priced, foreign banks presumably welcomed the move, which nonetheless does potentially subject them to window guidance. The Ministry of Finance reportedly may even permit foreign brokers as well as other new participants into the short-term money market, which remains a critical part of the transmission process for BOJ policy. If that should happen, foreign institutions would in effect become lieutenants in future BOJ monetary initiatives. BOJ reportedly has raised objections to having more participants in this process.

• In January this year BOJ began using treasury bills in market operations. However, the T-bill market is small. Late last year outstanding treasury bills amounted to Y4 trillion ($26.7 billion at Y150=$1.00), a small fraction of the short-term money market; outstanding call loans and bills in early 1990 totaled Y40 trillion ($266.7 billion). The T-bill market reportedly will rise to an average level of Y7.5 trillion ($50 billion) in FY 1990 and to Y10 trillion ($66.7 billion) in FY 1991. If BOJ were to use financing bills, another type of short-term government security that so far totals about Y20 trillion ($133.3 billion), its market operations using government securities could increase significantly. However, financing bills are not issued at market interest rates, limiting their usefulness.

Press reports suggest that MOF and BOJ are contemplating still more kinds of market operations, including an option that would involve consolidated bills backed by government securities. No timetable has been suggested for this innovation, however.

Taken together these recent moves show a definite pattern: BOJ is expanding open-market operations at the expense of direct lending to banks. As such, these measures suggest a continuation of a process that began in the 1970s of moving closer to the Fed style. Other indications point to a larger role for foreign banks in the implementation of monetary policy in Japan. At the same time, though, the liberalization process is far from complete. Window guidance remains in force. For example, BOJ, concerned about inflationary pressures, reportedly is pressing banks to restrain their lending significantly in the July-September 1990 period. In addition, the use of short-term government securities for open-market operations, a fixture of monetary policy elsewhere, remains severely limited.

Monetary Policy in Action

Assuming that a central bank believes monetary policy can play a useful role, it has a further choice to make: what means should it use to influence the economy? Central banks generally have chosen one of two possible targets: interest rates or the money supply. If the central bank decides to try to change interest rates the idea is to influence intermediate variables, such as the money supply, that affect the level of aggregate demand and output. Alternatively, the central bank can choose a money supply target directly.

Using the second operating rule, a central bank will take actions to drain reserves from the banking system if it wants to tighten money, stopping

when it believes the money supply has reached the target level. The effect might well be the same as moving to raise interest rates. Some experts have advocated the money supply approach since an interest rate target may not adequately reflect expected inflation. If the central bank selects a higher nominal rate, it inadvertently may be accommodating a lower real rate if firms expect inflation to pick up. One problem with a money supply operating rule is picking the correct measure among several different money supply concepts.

The evidence suggests that BOJ uniformly selects the interest rate operating rule and focuses on interbank rates, such as the call rate and the commercial bill rate. In this context a change in the discount rate sends a clear signal about desired market rates. The more recent practice of open-market operations involving commercial bills or other instruments in support of interest rates sends a similar message. In selecting an interest rate operating rule, BOJ is substantially in accord with recent Fed practice, according to Michael Dotsey of the Federal Reserve Bank of Richmond.[7]

Experience since 1987 shows the apparent wisdom of BOJ's approach. Money supply growth in Japan has been rapid by most measures (see Table 1). The most widely used measure of monetary growth, M2+CDs, which is more than four times as large as narrowly defined M1, has grown in recent years at annual rates close to or in double digits. Despite this fact, price increases have been small, and sometimes even negative, on an annual basis. For example, between 1985 and 1989 the GNP price deflator, a broad measure of inflation, varied from -0.3 percent in 1987 to 1.8 percent in 1986. These results suggest that a strict monetary operating rule, which almost certainly would have set targets far below the observed growth of M2+CDs, probably would have been too restrictive.

After peaking in 1980 interest rates began a steady decline that lasted through 1987. They began creeping up again in 1988, with sharp rises toward the end of 1989 and into the early months of 1990 (see Tables 2 and 3). Long-term rates appear to have lagged short-term rates during periods of both declines and increases. In part, this pattern may have reflected a slowly growing perception of lower inflation rates after the early 1980s. In other words, buyers of long-term securities initially demanded compensation for inflation based on Japan's experience during the two oil crises of the 1970s when prices jumped. But as expectations of inflation diminished steadily between 1980 and 1989, the required offset shrunk, too.

Since 1985 new factors have appeared that have not yet completely played out. In line with international agreements concerning currency realignment Japan began to reflate its economy in 1986. The discount rate was cut four times that year and again in early 1987, and the money supply expansion was accelerated. These moves complemented efforts starting in late 1985 to boost the value of the yen, which reduced overseas demand for Japanese exports below what it otherwise would have been. In other words, monetary policy was assigned the task of picking up the slack that presumably would have existed in the economy given the impact of the higher yen on exports. The lower interest rates were designed to stimulate domestic demand and thus lift the economy and reinforce the boost to imports that the stronger yen was to give.

[7]Michael Dotsey, "Japanese Monetary Policy: A Comparative Analysis," Economic Review, November/December 1986, p. 19.

Table 1: Changes in Money Supply and Prices in Japan, 1980-90

(percent change from year-earlier period)

	M1	M2+CDs	Wholesale Prices	Consumer Prices
1980	2.6%	9.2%	17.8%	7.7%
1981	3.3	8.9	1.4	4.9
1982	5.8	9.2	1.8	2.8
1983	3.6	7.4	-2.2	1.9
1984	2.8	7.8	-0.3	2.3
1985	5.0	8.4	-1.1	2.0
1986	6.9	8.7	-9.1	0.6
1987	10.5	10.4	-3.7	0.1
1988	8.4	11.2	-1.0	0.7
1989	4.1	9.9	2.5	2.3
1990				
January	0.5	11.5	3.7	3.0
February	0.7	11.8	3.5	3.6
March	0.8	11.6	3.9	3.5
April	0.4	13.2	2.7	2.5
May	-0.6	13.2	1.7	2.7

Notes: M1 equals currency in circulation plus "deposit money" (yokin tsuka, a concept roughly comparable to demand deposits).

M2+CDs equals M1 + quasimoney (public and private deposits at surveyed financial institutions excluding demand deposits) + certificates of deposit at surveyed financial institutions.

Sources: Bank of Japan and Management and Coordination Agency

Rapid monetary expansion, as explained earlier, necessarily is reflected in some combination of increased output, higher inflation and/or changed velocity. Obviously, BOJ officials hoped that output would be the most affected by these moves; the situation suggested this was likely. The yen's appreciation created an incipient deficiency of aggregate demand that monetary policy could help reverse. In addition, by the late 1980s Japan had a long record of price stability, suggesting that the hyperinflation of the 1940s and the double-digit inflation of the early 1970s were fading memories. In practical terms this meant that Japanese consumers and firms would not develop an inflation psychology. As a result, they would not try to get rid of their money quickly and thereby boost velocity, which would have contributed to a self-fulfilling prophecy concerning inflation.

In many ways these expectations have proved true. Gross national product eked out a mere 2.5 percent inflation-adjusted gain in 1986, in part a measure of the initial impact of the yen's appreciation. However, as the new, looser

Table 2: Representative Interest Rates in Japan, 1980-90

	Two-Month Bill Rates	Collateral Call Rates	10-Year Government Bond Yields
1980	10.0%	10.9%	8.8%
1981	7.9	7.4	8.1
1982	7.0	6.9	7.6
1983	6.6	6.4	7.4
1984	6.3	6.1	6.5
1985	6.6	6.5	5.9
1986	5.0	4.8	5.2
1987	3.9	3.5	5.1
1988	4.1	3.6	4.7
1989	5.3	4.9	5.7
1990			
January	6.8	6.4	6.6
February	7.0	6.5	6.9
March	7.4	6.6	6.9
April	7.3	7.0	6.9

Source: Bank of Japan

monetary policy increasingly took hold, real GNP increased 4.6 percent in 1987, 5.7 percent in 1988 and 4.9 percent in 1989 despite a continuing drag from net exports and, in 1989, a BOJ policy shift. As such, real GNP growth represented a sharp upturn from the 1980-85 period when it had averaged 3.9 percent a year. In addition, as noted in Table 1, prices showed remarkable stability. Velocity, rather than rising, showed a sharp decline between 1987 and 1989.

The increase in output, however, did not account for all the growth in the money supply. While the prices of goods and services failed to explode, a number of other prices did. For example, between 1985 and 1989 the Nikkei average of 225 stocks listed on the Tokyo Stock Exchange rose from Y12,556 to Y34,043. Similarly, land prices climbed; the cost of land in Japan's six largest cities jumped 84 percent between 1985 and 1988 and continued rising in 1989. (For details of 1989 land price increases using a different data series, see JEI Report No. 14B, April 6, 1990.) The result was just the reverse of what had happened in the aftermath of World War II; financial and other assets rose sharply compared to nominal GNP. The phenomenon is referred to as "asset inflation."

Asset inflation explains in part why velocity, a measure of money relative to nominal GNP, declined. Some of the increased money supply was diverted into the trading of assets. Put differently, money was less intensively used for goods and services because its role as a means of trading assets became more important. Had the rapid increase in money flowed into goods and services rather than assets, the prices of goods and services would have risen far more than they did.

Asset inflation had another dimension. Low interest rates -- the counterpart of the higher money supply -- made stocks and land attractive. To the

Table 3: Discount Rate in Japan, 1979-90

Effective Date	Rate
November 2, 1979	6.25%
February 19, 1980	7.25
March 19, 1980	9.00
August 20, 1980	8.25
November 6, 1980	7.25
March 18, 1981	6.25
December 11, 1981	5.50
October 22, 1983	5.00
January 30, 1986	4.50
March 10, 1986	4.00
April 21, 1986	3.50
November 1, 1986	3.00
February 23, 1987	2.50
May 31, 1989	3.25
October 11, 1989	3.75
December 25, 1989	4.25
March 20, 1990	5.25

Source: Bank of Japan

extent that money was used for stock and land transactions, investors had reason to hold more money as asset prices rose. In short, rises in the broadly defined money supply and other asset demand were mutually reinforcing.

Changing expectations of price increases had a similar effect. The shrinking inflation of the mid-1980s reduced the risk that people with certificates of deposit, for example, would experience a decline in the real value of their instruments. As a result, the demand to hold these instruments increased and the velocity of the money supply fell.

As long as M2+CDs and asset prices influenced mainly each other and were accompanied by falling velocity, the phenomenon could be regarded as a tempest in a financial teapot. In 1989, however, BOJ increasingly became concerned that the situation could change. To the extent that the monetary expansion flowed into demand for goods and services, BOJ no longer could count on higher output rather than price increases. Capacity utilization was rising and labor shortages, as measured by the openings-to-applicants ratio, loomed (see JEI Report No. 26B, July 6, 1990). In addition, the bank's measures of potential price inflation showed sharp jumps in 1988 and 1989. As a result, BOJ reversed course, raising the discount rate four times in a 10-month period, with the most recent increase, to 5.25 percent, coming in March 1990 (Table 3).

The accompanying interest rate hikes set off alarm bells among investors. The Nikkei average plummeted from a high of Y38,916 December 29, 1989 to Y28,062 April 2 before staging a partial recovery in the late spring. The Nikkei ended June at Y31,940. During the same period bond prices and the yen followed bumpy paths similar to that of the stock market. The experience suggests that investors became nervous about holding Japanese financial assets. To the extent this was true BOJ had even more reason to worry that any future increases in M2+CDs would fuel inflation in goods and services rather than assets.

Other Issues

The combination of an appreciating yen and monetary expansion required deft BOJ handling. Normally, a looser monetary policy implies a fall in the value of a country's currency as the increased liquidity spills over into international markets, increasing the currency's supply and depressing its value. The yen's appreciation between early 1985 and late 1988 in the face of rapid monetary expansion suggests that BOJ effectively prevented monetary policy from influencing the exchange rate. Some American experts believe that the weakness of the yen from late 1988 to at least mid-1990 reflects a delayed reaction to earlier Japanese monetary policy. However, the yen remains comfortably above rather than below 1985 levels as this theory would predict.

Of course, part of the explanation involves interest rate changes overseas. Despite an accommodating monetary policy in Japan, which by itself would have tended to widen interest rate differentials, interest rate gaps showed an uneven pattern. For example, long-term interest rates in Japan fell in 1986, but U.S. rates dropped even faster. Therefore, while long-term rates were 4.3 percentage points higher in this country in 1985, they were only 2.7 points above Japanese rates the following year, according to calculations by the Bank for International Settlements.[8] As a result, yen-denominated investments became more attractive, boosting the value of the Japanese currency.

This example illustrates the interdependence of monetary policies across countries. Japanese policy, for example, necessarily takes into account foreign factors, whether monetary policies abroad or shifts in the demand for capital in regions such as Eastern Europe. Of course, as the Japanese economy has grown, the effects of BOJ's monetary policy on the rest of the world has increased as well. Federal Reserve Board officials were on record in 1989 as saying that foreign influences on interest rates have complicated their job; similar statements have been heard this year.[9]

In addition to the level of complexity added by the internationalization of financial markets, institutional factors may be complicating the conduct of

[8]Fifty-Eighth Annual Report (Basle, Switzerland: Bank for International Settlements, 1988), p. 82.

[9]For an econometric measurement of this influence, which presents findings only of the aggregate influence of Japan and nine other industrial nations on U.S. interest rates, see Lawrence J. Radecki and Vincent Reinhart, "The Globalization of Financial Markets and the Effectiveness of Monetary Policy Instruments," Federal Reserve Bank of New York Quarterly Review, Autumn 1988, pp. 18-27.

monetary policy in Japan. Some observers see signs of change in how the Bank of Japan views its role vis-a-vis the Ministry of Finance. Unlike the Federal Reserve Board in the United States, which is independent of the Department of the Treasury, BOJ is tied closely by law and tradition to MOF. As a result, the bank seldom acts independently. Alternate BOJ governors come from MOF; the remainder are promoted from within BOJ itself. The current governor, Yasushi Mieno, is a BOJ man.

According to a number of BOJ watchers, the central bank is striving for more independence. In a couple of recent instances involving possible discount rate increases, BOJ and MOF have had what independent observers have interpreted as disagreements about the need for such boosts. (The increases eventually were adopted.) In addition, BOJ reorganized itself at the end of May, establishing new information-collecting capabilities. At least one analyst has speculated that the reorganization was intended to give the bank de facto control over decisions that otherwise might be considered the province of MOF. For its part, MOF in 1989 established a money market monitoring section that one BOJ official described as unnecessary "unless it is meant to monitor the BOJ."

Such tension, if it exists, hardly would be surprising. By their nature finance ministries and central banks are likely to be at loggerheads. Central banks typically see their preeminent role as preventing inflation. Finance ministers (or treasury secretaries), who are likely to be far more attuned to political developments, worry more about avoiding recessions and preventing interest rate increases that they see as harming consumer interests. For example, in early July Treasury Secretary Nicholas Brady said (concerning Fed policies): "It seems to me that it's not a wise idea to emphasize an undying, forever, attack on inflation if it jeopardizes growth in this country."

The national debt often looms large in disputes between the two groups. As the organization charged with financing the national debt, MOF -- like Treasury -- has a direct interest in low interest rates. Central banks put far more weight on the ability to adjust interest rates to a level appropriate to the state of the economy. For example, BOJ has advocated that financing bills be sold at auction. One effect of that action would be to increase the usefulness of this instrument in monetary policy. Currently, BOJ ends up holding a disproportionate share of financing bills because of the low interest rate (high issue price) the bills carry. To date MOF has resisted BOJ's proposal successfully on the grounds that the cost of financing the Japanese national debt would rise.

The two types of organizations are particularly likely to have conflicts over the regulation and the monitoring of financial institutions, for which they share responsibility in both the United States and Japan. This last concern appears to have come to the fore recently in both countries. As BOJ lending to banks has declined in importance, the central bank has sought new ways of exerting its will on the banking system. Under former chairman Paul Volcker the Fed reportedly resisted changes in banking regulations and supervision, whether by shifting responsibility to other government agencies or otherwise, that would have lessened Fed authority. (As of June 1990 the Fed's stance was said to be "evolving.")

Prospects

BOJ has plenty on its plate at the moment. Besides the ever perilous state of money markets, it has a recent reorganization to digest. Some analysts believe the bank is looking over its shoulders at MOF. With respect to the economy, statements by BOJ officials in June suggested they were waiting to see what would happen as a result of the recalibration of monetary policy in the spring. The capacity constraints in the Japanese economy have not disappeared despite continuing high rates of plant and equipment spending. This suggests that BOJ officials will have to tread a fine line between assuring adequate financial resources to accommodate continuing -- albeit slower -- expansion and an excessively loose monetary policy that could set off inflation. Furthermore, sudden lurches in policy could panic investors holding financial and other assets, which remain at very high levels by historical standards.

In monetary policy past events influence the efficacy of proposed policies, making reactions uncertain. For this reason the Bank of Japan finds itself constantly navigating new territory. Furthermore, recent innovations in the instruments of monetary policy put BOJ in the position of making this trip into the unknown using unfamiliar vehicles. Having maintained the Japanese economy on a growth path in the 1980s while avoiding inflation, the central bank has accumulated a strong record of credibility. The bank's reputation probably will grow if, as now appears likely, it successfully meets the challenges of the current decade.

For further information, contact Douglas Ostrom.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.